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In the Supreme Court of the United States

OCTOBER TERM, 1978

LIBERTY LIFE INSURANCE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The opinion of the district court (Pet. App. A 1a-13a) is reported at 439 F. Supp. 927. The opinion of the court of appeals (Pet. App. D 16a-30a) is reported at 594 F. 2d 21.

JURISDICTION

The judgments of the court of appeals (Pet. App. F 36a-37a) were entered on March 8, 1979. The petition for a writ of certiorari was filed on June 6, 1979. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether a portion of a state tax on domestic insurance companies, in an amount equal to two percent of premiums, but not to exceed five percent of net

income, may be allocated to investment expenses for federal income tax purposes under Section 804(c)(1) of the Internal Revenue Code of 1954.

2. Whether the difference between the amount of mortgage cancellation policy premiums that were paid on an annual basis and the total premiums that would have been payable on a monthly basis was deductible "discounts in the nature of interest" on advance premium payments within the meaning of Section 805(e)(3) of the Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 804 and 805 of the Internal Revenue Code (26 U.S.C.), Treasury Regulations on Income Tax, Sections 1.804-4 and 1.805-8 (26 C.F.R.), and S.C. Code § 37-130.1 (1962), are set forth in the Appendix, *infra*, 1a-6a.

STATEMENT

1. *The state premium tax issue.* Petitioner is a stock life insurance company chartered under the laws of South Carolina, with its principal place of business in that state (Pet. App. A 2a). As a domestic life insurance company, petitioner was subject to an annual "graded license fee" in the amount of two percent of its total premium receipts from within South Carolina subject to a maximum limitation of five percent of net income for the year in question (Pet. App. A 5a-6a). See S.C. Code § 37-130.1 (1962), Appendix, *infra*, 5a-6a.

In 1965, petitioner would have been subject, but for the limitation provided for by the statute, to a license fee of $475,946.42, which was two percent of its premium receipts for that year. Under the maximum limitation,

however, its license fee for 1965 was limited to $222,911.93, which is five percent of its net income (Pet. App. A 6a).

Petitioner did not reflect any portion of the South Carolina license fee as an investment expense on its annual statement filed with the states in which it did business (R. 16, 192-193, 739).[1] On its 1965 federal income tax return, petitioner claimed a deduction of $47,159.42 of this license fee as an "investment expense" under Section 804(c)(1) of the Code, thereby reducing the "taxable investment income" component of its overall taxable income. This allocation was based on the ratio of petitioner's gross investment income to its total gross income (R. 14). On audit, the Commissioner of Internal Revenue disallowed the deduction, and required the fee to be treated entirely as an insurance expense deductible only in the computation of "gain from operations" under Section 809(d)(12) (R. 15). Petitioner paid the additional taxes determined to be due, and filed a claim and a supplemental claim for refund (Pet. App. A 2a).[2]

Upon denial of its claims for refund, petitioner instituted this action in the United States District Court for the District of South Carolina. The district court upheld the Commissioner's position (Pet. App. A 2a). It observed that the state license fee was based solely on the receipt of premiums from within the state, subject only to a maximum limitation based on overall net income. It

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[1] "R." refers to the record appendix filed in the court of appeals.

[2] In a supplemental claim, petitioner sought to allocate $173,344.75 of this license fee to investment expenses (Pet. App. A 6a). This amount represents five percent of the investment income component of the total net income taken into account in determining the maximum amount of the tax (R. 15).

therefore concluded that the fee was not incurred as a result of conducting investment activity within South Carolina and that no portion could be treated as an "investment expense" (Pet. App. A 11a-12a).

The court of appeals affirmed. It likewise ruled that the South Carolina statute taxes only premium income and that the "fortuity" that investment income is taken into account in determining the maximum limit does not alter the essential character of the state tax (Pet. App. D 18a-19a).

2. *The premium discount question.* During the years at issue, petitioner offered mortgage cancellation insurance designed to provide for the payment of a borrower's remaining indebtedness at the time of his death. This insurance was sold through savings and loan associations, which were the designated beneficiaries, and which also received commissions on premiums received. When this form of insurance was first offered by petitioner, premiums were paid by the borrowers to the associations and remitted by the associations to petitioner on a monthly basis (Pet. App. A 6a).

In 1964, petitioner agreed to accept annual payments from the associations at the beginning of the period of coverage in amounts less than the aggregate amount of monthly payments that would otherwise have been due from them over the course of the year. The associations, however, generally continued to collect premiums from the borrower on a monthly basis (Pet. App. A 6a-7a). In 1956, petitioner began to offer a choice on its policy forms between annual and monthly "modes" of payment, with the monthly premium calculated as a percentage of the annual rate (Pet. App. A 7a).

On its 1965 federal income tax return, petitioner deducted the difference between the total amount of mortgage cancellation premiums paid on an annual basis and the amount that would have been received had these premiums been paid on a monthly basis, as "discounts in the nature of interest * * * on premiums or other consideration paid in advance" under Section 805(e)(3) of the Code of 1954 (Pet. App. A 7a). Although the Commissioner did not question this treatment during the initial audit, the government challenged petitioner's entitlement to such a deduction in the district court by way of an offset against any refund that would otherwise be due (R. 7).

The district court upheld the government's position that petitioner was not entitled to a Section 805(e)(3) deduction. It ruled that this "discount" arrangement represented simply an annual mode of payment (rather than an advance payment of monthly premiums) and that the "discount" on such annual payments was not "in the nature of interest" (Pet. App. A 12a-13a). The court's holding was based on its findings that: (1) the method used in deriving a monthly rate from an annual rate was characteristic of ordinary conversions of premiums from one "mode" of payment to another; (2) a policyholder was entitled, on cancellation, to receive only a pro rata portion of the annual premium attributable to future months, (3) the annual premium did not reflect simply the "present value" of monthly premiums otherwise payable, (4) the "discount" on annual payments would, if converted into a rate of interest, substantially exceed the rate of interest paid by petitioner in the case of advance premium deposit arrangements, (5) petitioner enjoyed substantial expense savings where such premiums were paid on an annual basis, (6) petitioner also enjoyed competitive advantages in allowing mortgage cancellation

premiums to be paid, at a reduced rate, on an annual basis, and (7) petitioner failed to file informational returns reporting any "interest" payments based on these arrangements (Pet. App. A 7a-8a).

The court of appeals affirmed (Pet. App. D 23a-30a). In so holding, it relied on the district court's findings that petitioner did not calculate its annual mortgage cancellation insurance premium by computing the present value of future payments. Rather, the real interest factor in the discounts at issue was substantially higher than that used to calculate its advance premium deposit arrangements. As the court of appeals observed, "[w]e think that these facts demonstrate quite clearly that the discount claimed here bore little or no relation to the amount which [petitioner] expected to earn during the year 1965 on the annual premiums deposited by the associations, and therefore, the discount was not 'a discount in the nature of interest' " (Pet. App. D 27a).

ARGUMENT

1. *State premium tax issue.* Life insurance companies are taxed pursuant to a distinct statutory scheme. Sections 801-820 of the Internal Revenue Code of 1954 (as added by Section 2(a) of the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112-138) provide for a series of three computations or "phases" directed at determining the various components of a life insurance company's overall "life insurance company taxable income" under Section 802(b). In general, the net result of these computations is to impose a tax currently on the company's "taxable investment income" (that portion of net investment yield not deemed necessary for the fulfillment of policyholder obligations), plus half of its underwriting income (*i.e.*, half of the amount by which the company's overall "gain from operations," as determined under Section 809 of the Code exceeds taxable investment income as determined under

Sections 804 and 805). See *United States* v. *Atlas Insurance Co.*, 381 U.S. 233 (1965); *Commissioner* v. *Standard Life & Accident Insurance Co.*, 433 U.S. 148 (1977). Since the tax on the remaining half of the company's underwriting gains will generally be deferred until such sums are distributed to stockholders,[3] it is ordinarily to the company's advantage to shift as much of its income as possible to the underwriting computation and as many of its deductions as possible to the "taxable investment income" computation.

The decision below correctly held that the state premium taxes paid by petitioner were deductible only as underwriting or insurance expenses deductible under Section 809(d)(12) of the Code (since redesignated as Section 809(d)(11)), and not as "investment expenses" deductible under Section 804(c)(1). The question whether such an item can be allocated or apportioned between investment expense and underwriting expense is not new to the present statutory scheme enacted in the 1959 Act. It first arose as early as 1921 when the income tax on life insurance companies was limited to their free investment income (an amount roughly equivalent to the "taxable investment income" under the present statute). See Sections 242-247 of the Revenue Act of 1921, ch. 136, 42 Stat. 261-264. It was established from the outset that the "taxes imposed by the State on premiums" were nondeductible items because they belonged to the "nontaxable end of [the company's] business." *Hearings on H.R. 8245, Internal Revenue, Before the Senate Comm. on Finance*, 67th Cong., 1st Sess. 90 (1921)

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[3] The underwriting income not taxed in the first instance is added to a "policyholder's surplus account" pursuant to Section 815 of the Code. Subsequent distributions (or other reductions) of this account are included, at that time, in the company's taxable income under Section 802(b)(3).

(statement of Dr. T.S. Adams, Tax Adviser to the Treasury Department). See 8 J. Mertens, *Law of Federal Income Taxation* § 44.38, at 138 & 145-146 (Rev. 1978).

Such a tax on premiums is imposed by most states and is the "normal form of taxation [of life insurance companies] at the state level" (1 T. Nash, *Federal Taxation of Life Insurance Companies* § 4.07, at 4-15 (1977)). The only thing that would serve to distinguish the "graded license fee" imposed by South Carolina from other state premium taxes is the fact that it is subject to a maximum limitation based on a percentage of the company's overall net income. But as the court of appeals correctly pointed out, the adoption of such a limitation "does not convert the premium fee into a tax on investment income. The fortuity that the legislature chose a formula which included investment income to determine the maximum limit of the tax does not alter the character of the fee itself" (Pet. App. D 19a).

Accordingly, the courts below correctly rejected petitioner's contention that the tax in question is a tax on the privilege of doing *all* types of business—including investment business—within the state. Indeed, it is wholly irrelevant under the South Carolina statute where the company's income other than premiums is derived, or whether it does any other type of business at all within the state. Only the receipt of premiums from within the state is taxed, not the receipt of other types of income. The fact that a company enjoys the benefit of a limitation on the amount of that tax furnishes no basis for treating any portion of that limited tax liability as an expense "fairly chargeable against gross investment income." Treasury Regulations on Income Tax, Section 1.804-4(b)(1)(i), Appendix, *infra*, 3a.

2. *The premium discount question.* The decision below also correctly held that petitioner was not entitled to a deduction under Section 805(e)(3) for discounts in the nature of interest for the difference between the annual and monthly modes of payment of mortgage cancellation premiums. Section 805(e)(3) provides for an "interest paid" deduction in computing "taxable investment income" for "discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts." But in order for such a premium adjustment to qualify for deductions, the company must establish that the reduced or "discounted" premiums in fact represent "premiums * * * paid in advance" and that the reduction or "discount" is actually "in the nature of interest." Here, petitioner's claimed deduction fails on both counts.

First, the reduced annual payment is not a premium paid in advance. Life insurance companies have long offered their policyholders the option of paying premiums on conventional policies either annually or in semi-annual, quarterly or monthly installments. See *Commissioner* v. *Standard Life & Accident Insurance Co.*, *supra*. When the policyholder elects to pay on an annual basis, however, he is not considered to have made an advance payment on future premiums, even though such a premium is paid at the outset of the annual period of coverage.[4]

Second, while the company imposes an additional charge when the policyholder elects to pay his premiums in installments, to compensate it for the loss of investment income it would otherwise earn,[5] the difference between

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[4]As the court of appeals noted (Pet. App. D 27a), Congress did not intend to treat such premiums as "premiums * * * paid in advance" within the scope of Section 805(e)(3).

[5]See, *e.g.*, J. Maclean, *Life Insurance* 107 (9th ed. 1962).

the premiums paid on an annual "mode" and the amount paid over the course of the year when paid on a semi-annual, quarterly or monthly mode, is not considered to be "interest" from either the company's or the policyholder's standpoint. As the district court observed (Pet. App. A 7a), the difference between the annual payment and the sum of the monthly payments on the mortgage cancellation policies is simply a function of the difference between "modes" of payment. The difference between the payment options extended here is analogous to the optional modes of premium payment generally available to the holders of conventional life insurance policies. Indeed, while the mortgage cancellation premiums were originally paid solely on a monthly basis, more recent mortgage cancellation policies issued by the petitioner expressly provided for the payment of premiums "annually, semi-annually, quarterly, or monthly, *according to the Mode of Premium Payments*" (emphasis added) (R. 845).

Finally, as the district court (Pet. App. A 7a-8a) and the court of appeals (Pet. App. D 28a) concluded, the characterization of the annual payments as simply another mode of payment (rather than as advance payment of 12 monthly premiums) is unaffected by petitioner's election to report its reserves on the "mid-terminal" basis rather than on the "mean" reserve method characteristically used in the case of conventional life insurance. The method of reporting reserves is irrelevant to the question presented here because petitioner was free to use either method of reporting. In sum, there is nothing in the terms of Section 805(e)(3) or in the legislative history that would suggest that an annual payment mode could be regarded as the payment of advance premiums

simply because the company does not assume an annual payment in computing its reserves.[6]

At all events, the decision below correctly concluded that the difference between the annual and monthly modes of payment was not "in the nature of interest" within the meaning of Section 805(e)(3). While the legislative history of Section 805(e)(3) is somewhat scant, the Senate Committee report accompanying the 1959 Act confirms the congressional understanding that all items included under Section 805(e) "are similar in nature to the deduction for interest paid or credited on deposits by a bank." S. Rep. No. 291, 86th Cong., 1st Sess. 16-17 (1959). See also H.R. Rep. No. 34, 86th Cong., 1st Sess. 10 (1959). In enacting the "discounts in the nature of interest" provision of Section 805(e)(3), Congress intended to eliminate a distinction that had been drawn under prior law between advance premium deposit arrangements and economically equivalent arrangements under which the company agreed to accept as full payment the present value of the future premiums. Interest paid deductions had been held allowable in the former case in which the company becomes the policyholder's debtor (see *Equitable Life Assurance Society* v. *Commissioner*, 44 B.T.A. 293, 309-310 (1941), modified and aff'd on other grounds, 137 F. 2d 623 (2d Cir. 1943), aff'd, 321 U.S. 560 (1944)) and disallowed in the latter case (see *Illinois Life*

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[6]In computing mean reserves, full annual payment is generally assumed, whether or not it has in fact been paid by the end of the calendar year. See *Commissioner* v. *Standard Life & Accident Insurance Co.*, *supra*, 433 U.S. at 150. Conversely, as petitioner points out (Pet. 7), the "mid-terminal" reserve does not reflect the receipt of premiums attributable to periods beyond the end of the calendar year, even though they may actually have been paid on an annual basis.

Insurance Co. v. *Commissioner*, 30 B.T.A. 1160, 1164-1165 (1934), aff'd on another issue, 80 F. 2d 280 (7th Cir. 1935), rev'd on such other issue, 299 U.S. 88 (1936); *Monarch Life Insurance Co.* v. *Commissioner*, 38 B.T.A. 716, 727 (1938), aff'd, 114 F. 2d 314 (1st Cir. 1940)).

Here, however, the annual payment mode was not economically equivalent to the advance premium deposit arrangements petitioner extended to its policyholders in other circumstances. The "discounts" in this case reflected effective interest rates ranging between 7 and 14 percent per annum, which exceeded the 3 1/2 and 4 percent per annum interest petitioner allowed under its advance premium deposit agreements.[7] Indeed, as the court of appeals noted, the discounts bore little or no relationship to the amounts petitioner could expect to have earned on its investments in the period in question (Pet. App. D 27a). In short, unlike the discount arrangements involved in *Monarch Life* and *Illinois Life*, the annual premium did not reflect simply the "present value of the future amount due" (*Commissioner* v. *Monarch Life Insurance Co.*, *supra*, 114 F. 2d at 326).

Moreover, petitioner's position that its rate adjustments were "discounts in the nature of interest" is contrary to the proviso of Treasury Regulations, on Income Tax, Section 1.805-8(b)(2) (Appendix, *infra*, 4a), that "[a]mounts in the nature of interest do not include amounts derived from or representing mortality gains, expense savings, underwriting profits, or other items not in the nature of interest." As the district court noted (Pet. App. A 8a), the reduction permitted to those

[7]The arrangement here was also unlike an advance premium deposit because no interest was credited on refunds and the policyholder received only a pro rata portion of the amount actually paid.

policyholders who remitted their premiums on an annual basis represented, in large measure, reduced commissions payable on annual payments and the reduced recordkeeping costs when premiums were paid annually. In sum, since the difference between the annual and monthly modes of payment did not represent compensation paid for the use of the policyholder's money, the decision below correctly held that it was not a discount "in the nature of interest."

Finally, although petitioner acknowledges (Pet. 18) that this case is the first appellate decision on both of the questions presented, it contends that there is a potential for conflict on the premium discount issue with *Liberty National Life Insurance Co.* v. *United States*, 39 A.F.T.R. 2d 77-540 (N.D. Ala. 1976), appeal pending, No. 77-1578 (5th Cir. argued April 15, 1979), and that the court should hold the petition to await the decision of the Fifth Circuit in that case (see Pet. 13). But since the filing of the petition, the Fifth Circuit has reversed the decision of the district court in that case. It has held that the difference between the weekly premiums and the annual and semi-annual premiums was not "discounts in the nature of interest" within the meaning of Section 805(e)(3). *Liberty National Life Insurance Co.* v. *United States*, No. 77-1578 (5th Cir. August 13, 1979). There is accordingly no conflict of decisions warranting review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1979

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 804 [as added by Section 2(a) of the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 115] TAXABLE INVESTMENT INCOME.

* * * * *

(c) *Investment Yield Defined.*—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) *Investment expenses.*—Investment expenses for the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed the sum of—

(A) one-fourth of one percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year,

(B) the amount of the mortgage service fees for the taxable year, plus

(C) whichever of the following is greater:

(i) one-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by this paragraph) exceeds 3 3/4 percent of the mean of the assets (as defined in

section 805(b)(4) held at the beginning and end of the taxable year reduced by the amount described in subparagraph (B), or

(ii) one-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees for the taxable year.

* * * * *

SEC. 805 [as added by Section 2(a) of the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 118] POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

* * * * *

(e) *Interest Paid.*—For purposes of this part, the interest paid for any taxable year is the sum of—

(1) *Interest on indebtedness.*—All interest for the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under this chapter.

(2) *Amounts in the nature of interest.*—All amounts in the nature of interest, whether or not guranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time fo accrual, life, health, or accident contingencies.

(3) *Discount on prepaid premiums.*—All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

* * * * *

Treasury Regulations of Income Tax (26 C.F.R.):

1.804-4 *Investment yield of a life insurance company.*

* * * * *

(b) *Deductions from gross investment income*—(1) *Investment expenses.* (i) Section 804(c)(1) provides for the deduction of investment expenses by a life insurance company in determining investment yield. "Investment expenses" are those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

* * * * *

1.805-8 *Interest paid.*

* * * * *

(b) *Interest paid defined.* For purposes of part I, subchapter L, chapter 1 of the Code,

the term "interest paid" as used in section 805(e) means the sum of—

* * * * *

(2) All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies. Amounts in the nature of interest do not include amounts derived from or representing mortality gains, expense savings, underwriting profits, or other items not in the nature of interest. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest accrued within the taxable year on such contracts. A contract to pay insurance benefits in installments over a specified period, for example, a contract to pay the insurance benefit in 10 annual installments, is considered as a supplementary contract not involving life contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by either the insured or a beneficiary after the policy matured. Thus, no distinction is made based on the person

choosing the method of payment, and the full amount of the interest accrued, and not merely the guaranteed interest, is considered as interest paid. Amounts in the nature of interest include interest on dividends left on deposit with the company and interest on premiums paid in advance.

(3) All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts. Such accrual shall be determined in accordance with the rules prescribed in section 818(b) and the regulations thereunder. For example, if at the beginning of the taxable year 1958 a life insurance company granted a discount in the nature of interest of $40 as the result of the prepayment of life insurance premiums for 5 years, the company may, under the straight line method, accrue $8 in 1958 and each of the four succeeding taxable years ($40 ÷ 5 = $8) and include this $8 as interest paid for each such taxable year.

* * * * *

S.C. Code §37-130.1 (1962):

Two per cent graded license fee on domestic life insurance companies. In addition to any and all other license fees or taxes there is hereby

imposed upon each domestic life insurance company of any class licensed by the Commissioner and incorporated under the laws of this State, an additional and graded license fee in an amount equal to two per cent of the total premiums, that is, total premium income or total premium receipts, from insurance contracts issued to residents of this State or paid from a point located within this State, less any dividends or bonuses paid in cash or applied in abatement of premiums or credited to policyholders of such company, as collected from citizens of or residents of this State during the year next preceding the date of the return. Such premiums shall not include considerations received from annuity contracts. The additional and graded license fee imposed in this section shall not exceed five per cent of the net income of the company as determined under the provisions of chapter 5 of Title 65; *provided*, that in addition to the deductions allowed by such chapter there shall be allowed in computing net income any addition to policy reserves as may be required by the Commissioner, but no more than such required amount.